Fed Watch

Fed slows to 25bp hike and recognizes that “the disinflationary process has started”

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Non-housing core services inflation and the labor market hold the key for a pause

- **As expected, the Fed kicked off the year by downshifting again its tightening pace with a 25bp hike, pushing the fed funds rate into a 4.50-4.75% target range, its highest level since late 2007 when the Fed made the first rate cut amid the outbreak of the global financial crisis.** The decision was unanimous, with the approval of this year’s voting regional Fed Presidents Austan Golsbee, Patrick Harker, Neel Kashkari, and Lorie Logan, who replaced James Bullard, Susan Collins, Esther George, and Loretta Mester. Today's hike is set to be one of the last before the Fed opts for a relatively long pause.

- **Tweaks to the wording signal that things are going better on the inflation front, but the Fed was careful not to hint that there may be only one more hike in the pipeline.** As we argued yesterday (see), the Fed retained the “ongoing increases” (more than one) reference while Powell was clear that at this moment a pause was not discussed as “there is work left to do.” In fact, changes to the policy statement only formalized the already-conveyed acknowledgment by several FOMC officials that “inflation has eased somewhat but remains elevated”, something that could be interpreted as a nascent formal dovish signal, though offset by the fact that the Committee continues to see an economy with "modest growth in spending and production" in which the "job gains have been robust in recent months, and the unemployment rate has remained low." For the first time since the onset of the COVID-19 emergency, the word “pandemic” was removed from the statement, together with some of the factors related to it and to the outbreak of Russia’s war against Ukraine that initially drove and later intensified the current inflationary cycle, i.e., supply and demand imbalances, high food and energy prices, and broad price pressures.

- **Recent mounting evidence that the economy appears to be already on a disinflationary process gave Powell less leeway to reinforce the required hawkishness to reverse the probably overoptimistic market’s expectation that inflation will come down faster than projected by the Fed.** During the press conference, Powell acknowledged that it is “gratifying” to see inflation down, and explained that the Fed is aware of the evidence that supports it. He elaborated that the Fed is confident that two of the three main components of core inflation are easing but warned that the most important, and more sensitive to the slack of the economy and the labor market (core services ex-housing), has not shown yet a disinflation trend. Core goods inflation is clearly on a descending trend while housing services inflation will come down assuming new leases continue to be soft (i.e., disinflation is in the pipeline). Yet, these two components represent less than half of inflation and thus, Fed’s eyes will remain on non-housing core services inflation. Powell said the Fed is not seeing “disinflation there yet, and until [they] do, [they] have to complete the job.” The Fed is uncertain about the timing and level of tightening needed for this component to ease, arguing that 55% of this component is closely related to the dynamics of the labor market, which continues to be “extremely tight.”

- **Bottom-line: the Fed stuck to its policy outlook stating that there is more to come -ongoing increases in plural signals two more 25bp hikes- as it is “strongly resolved” to complete the task of bringing down inflation to 2%, but also hinted that we are not very far from peak rates.** The Fed is slowing down to see the progress of the disinflationary process. Up until now, inflation is moving down steadily but not fast. The softening of the labor market is key. The Fed will have two more CPI inflation and job reports before the next meeting. With the Fed clearly signaling that it is getting to a point where it will be more data-dependent, signs of softening labor demand and easing core services inflation ex-housing will hold the key for the Fed to pause. The FOMC continues to think that it’s still very difficult to manage the risk of doing too little. But the message is clear: following 450bp worth of hikes, the Fed is starting to feel more comfortable with where rates are at, and thus, data will play into their policy. **We continue to think that incoming data will convince the Fed to pause at its May meeting after the fed funds rate peaks at the 4.75-5.00% target range following a last 25bp hike in March.**

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